87-1735

In The
Supreme Court of the United States

MARTIN H. FISHMAN
and
HARRIET FISHMAN,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee,

SEYMOUR N. LOGAN INSURANCE TRUST TRUST B, MILTON I. SHADUR, TRUSTEE,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee,

RENEE LOGAN,

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee,

HAROLD HALPERN,

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee,

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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No. ___

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v.
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QUESTION PRESENTED

Was the Seventh Circuit correct in the instant case, or was the Ninth Circuit correct in Hoopengarner v. Commissioner of Internal Revenue, 80 T.C. 583 (1983), aff'd by unpublished opinion 745 F.2d 66 (9th Cir. 1984), as to the deductibility of certain expenses under Section 212 of the Internal Revenue Code?

LIST OF PARTIES

The Appellant in the United States Court of Appeals for the Seventh Circuit was Respondent Commissioner of Internal Revenue. The Appellees in the Seventh Circuit (petitioners here) were Martin N. Fishman, Harriet Fishman, Seymour N. Logan Insurance Trust, Trust B,[*] Renee Logan and Harold Halpern.

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[*] Milton I. Shadur, now a United States District Judge for the Northern District of Illinois, was Trustee at the time the Petitions were filed in the Tax Court. He has since resigned as Trustee and a new trustee is now serving as Trustee.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The petitioners respectfully request that a writ of certiorari issue to review the judgment and decision of the United States Court of Appeals for the Seventh Circuit entered on January 12, 1988.

OPINIONS BELOW

The decision of the Court of Appeals for the Seventh Circuit from which certiorari is sought, dated January 12, 1988, reversing the decision of the Tax Court, is reported at 837 F.2d 309 (7th Cir. 1988). It appears as Appendix A hereto.

The decision of the United States Tax Court is reported at 51 T.C.M. (CCH) 738,

T.C. Memo 1986-127 (1986). It appears as Appendix B hereto.

JURISDICTION

The judgment of the United States Court of Appeals for the Seventh Circuit was entered on January 12, 1988, reversing the decision of the Tax Court. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

STATUTE INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.) Section 212.

STATEMENT OF THE CASE

Each of the petitioners in these cases was a partner[1] in the Johnstowne Center Partnership (the "Partnership"), which was formed in 1975 for the purposes of "leasing, constructing, developing and otherwise dealing with" a multi-unit commercial shopping center project on property in Champaign, Illinois. Although the Partnership did not begin to receive rental income until November 1, 1977, the Partnership was engaged in significant activities and incurred

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[1] The partners of the Johnstowne Center Partnership were petitioner Martin Fishman, petitioner Harold Halpern, and Seymour N. Logan Associates. Seymour N. Logan Associates is a partnership of Trust A and Trust B under the Seymour N. Logan Insurance Trust. All income from Trust A is and was distributable currently to petitioner Renee Logan. Trust B is the fourth petitioner.

significant expenses in 1976 and during the first 10 months of 1977.

The controversy arises out of losses reported by the Partnership on its 1976 and 1977 partnership returns attributable to expenses for ground rent and other ordinary and necessary items related to the project. The petitioners in turn claimed deductions on their respective income tax returns for their percentage shares of the losses reported by the Partnership. The Tax Court held that petitioners were entitled to the deductions they claimed (with certain exceptions not relevant here) under Section 212 of the Internal Revenue Code. The Seventh Circuit reversed the decision of the Tax Court.

REASON FOR GRANTING THE WRIT

There is a direct conflict between the decision of the Court of Appeals for the Ninth Circuit in Hoopengarner v. Commissioner of Internal Revenue, 80 T.C. 583 (1983), aff'd by unpublished opinion, 745 F.2d 66 (9th Cir. 1984), and the decision of the Court of Appeals for the Seventh Circuit in the instant case. The decision of the Tax Court in Hoopengarner, affirmed by the Ninth Circuit, held that ground rent expenses were deductible under Section 212 even though they were incurred and paid before a real estate venture received rental

income. The Seventh Circuit in the instant case rejected Hoopengarner.[2/]

Two other Circuit Courts of Appeals have disapproved Hoopengarner, although in neither case was the issue of ground

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[2/] The Seventh Circuit remanded to the Tax Court (837 F.2d at 314):

> In holding that the Tax Court erred in allowing the deduction of ground lease rentals, commitment fees, and other start-up costs, we bypass two questions that might affect the outcome. The first is when the start-up period ceased, that is, when the trade or business, in this case the business of operating a shopping center, began. Such questions arise frequently in cases governed by section 162 alone because the taxpayer is a corporation, see, e.g., Blitzer v. United States, 684 F.2d 874, 880-81 (Ct. Cl. 1982) (per curiam) (holding that a business may be said to have started before the actual receipt of income), and they should be decided the same way under section 212. The question remains for the Tax Court to decide on remand.

rent involved. See, Johnsen v. Commissioner, 794 F.2d 1157 (6th Cir. 1986), and Aboussie v. United States, 779 F.2d 424 (8th Cir. 1985). As the Seventh Circuit noted in this case (837 F.2d at 311):

> We must decide whether we agree with the Ninth Circuit or with the Sixth Circuit and the Eighth Circuit, which has also rejected Hoopengarner.

The issue has arisen in other cases as well, including Lewis v. Commissioner, 51 TCM 868, which is presently on appeal to the Tenth Circuit, No. 86-2762. The conflict among the circuits should be resolved.

In addition, according to the government, the revenue consequences are substantial. As the Seventh Circuit noted in its opinion in this case (837 F.2d at 311):

> Although an amendment to section 195 of the Internal Revenue Code requires that start-up costs incurred by individuals after July 1, 1984, be capitalized, the government's counsel told us at argument that there are thousands of pending disputes, involving in the aggregate many millions of dollars, over start-up costs incurred by individuals before the amendment went into effect -- so many disputes, indeed, involving so much money, that the government might have to ask the "Court of Nine" (as [government] counsel called it) to resolve the conflict among the circuits.

A. BRIEF STATEMENT OF FACTS

The Johnstowne Center Partnership (the "Partnership") was created by a partnership agreement dated August 21, 1975. The partnership agreement provided that the Partnership was organized for the purposes of "leasing, constructing, developing and otherwise dealing with the development of the Project." · The

agreement authorized petitioner Harold Halpern to execute as nominee for the Partnership an option agreement for an option to enter into a ground lease of the property.

On September 19, 1975, Mr. Halpern on behalf of the Partnership entered into a written option agreement (the "Option Agreement") with the owner of the property in question, the YWCA, by which the Partnership obtained an option to enter into a 50-year ground lease. Thereafter, the Partnership proceeded with efforts to find commercial tenants for the shopping center, to arrange for necessary financing and to make plans for construction.

Activities of the Partnership in 1976

On February 25, 1976, the Partnership signed its first lease with a commercial tenant, the Chin Lease. At the time that lease was signed, the Partnership received a security deposit from Chin. The Partnership entered into five other tenant leases in 1976, one in March, one in April, one in May, one in September and one in October. Security deposits were received in 1976 from each of those tenants. A sixth additional tenant lease (the Bivouac lease) was signed in 1976 and a security deposit received, but the tenant never took possession.

In July of 1976, the Partnership sent a notice exercising its option to lease the property in question under a 50-year ground lease from the YWCA. The ground

lease ("Ground Lease") was signed September 30, 1976.

In August of 1976, the Partnership received a permanent mortgage loan commitment in the amount of $900,000 from Mutual Home, an institutional lender.

In November of 1976, the Partnership received a construction mortgage loan commitment in the amount of $900,000 from Bussy National Bank, a construction lender.

On December 31, 1976, the Partnership entered into a construction contract with respect to the construction of the shopping center.

Petitioner Harold Halpern devoted approximately 40% to 50% of his time in 1976 to the activities of the Partnership.

Activities of the Partnership in 1977

When ground breaking for the shopping center took place in March of 1977, at least 1/3 of the space in the shopping center had been leased to commercial tenants.

The Partnership entered into five additional tenant leases in 1977, one in May, one in June, one in August, one in September and one in October of 1977, and security deposits were received from each tenant at the time its lease was signed.

In September of 1977, the Partnership advised its tenants that their space would be available on September 30, 1977 and that rent would commence on November 1, 1977.

Payments for Which Deductions Were
Claimed and Allowed by the Tax Court

Ground Rent

In 1976 and 1977 the Partnership paid $23,389 and $18,593 respectively in ground rent in accordance with the terms of the Option Agreement and the Ground Lease.3/

Commitment Fees

In 1976 the Partnership paid a $9,000 non-refundable fee to Mutual Home to obtain a permanent mortgage loan commitment. In 1976 the Partnership also paid $4,500, to Bussy National Bank representing one-half of the fee to obtain a temporary construction mortgage

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3/ Additional ground rent was paid in November and December of 1977 for which the Respondent allowed a deduction by the Partnership.

loan commitment. In 1977 the Partnership paid Bussy National Bank an additional $4,500 representing the balance of the fee to obtain the temporary construction mortgage loan commitment.

Letter of Credit Fee And Other Payments

In 1977 the Partnership paid $4,930.55 to obtain a letter of credit required by an amendment to the Partnership's Ground Lease. Other ordinary and necessary expenditures were also incurred by the partnership in 1976 and 1977.

B. THE ANALYSIS IN HOOPENGARNER WAS CORRECT AND SHOULD BE ADOPTED BY THIS COURT

In *Hoopengarner v. Commissioner of Internal Revenue*, 80 T.C. 583 (1983), *aff'd* by unpublished opinion, 745 F.2d 66

(9th Cir. 1984), the Tax Court held that payments of ground rent in 1976 were deductible under Section 212 even though the taxpayer did not receive any income in that year from the leasehold on which an income-producing building was subsequently built.

The Court noted that there is no trade or business required under Section 212, so that it was not necessary for the taxpayer to show that his trade or business had begun at the time of the ground rent expenditures at issue.

In the instant case, Respondent's principal argument in the Court of Appeals was that expenditures of the type at issue are capital expenditures. Thus, Respondent argued in its brief below (emphasis added in each instance): "Fundamental tax principles . . . require

the capitalization of the cost of acquiring a capital asset" (pp. 18-19); "Courts denying deductions based on the 'pre-opening expense doctrine' . . . have explained the rationale of their decisions by emphasizing the capital nature of the expenses involved" (p. 20); "Section 212 . . . does not permit the deduction of capital expenditures" (p. 24).

The Seventh Circuit concluded that expenses like ground rent incurred before the beginning of the operation of a business are capital expenditures and should not be deductible under Section 212.[4/]

[4/] As noted above, the Seventh Circuit remanded so that the Tax Court could determine whether in this case the business of operating a shopping center had begun at the time of the expenditures at issue.

We respectfully submit that the Seventh Circuit was wrong, and that the <u>Hoopengarner</u> decision was correct.

The Tax Court in <u>Hoopengarner</u> specifically discussed the issue of whether the expenditures for ground rent should be characterized as capital expenditures. Thus, the Tax Court stated (80 T.C. at 542):

> We are also cognizant of the fact that an expenditure that is otherwise deductible under section 212 cannot be deducted if it is capital in nature.

The Tax Court went on to hold that the ground rent payments in that case were <u>not</u> capital (80 T.C. at 542):

> Here, the rent paid during 1976 did not produce any equity that survived a year beyond the time that the payment was made. The possessory right received by petitioner in return for the rent attributable to 1976 was, of

> course, wholly consumed during that year and did not augment, or in any way increase, the value of the building constructed in 1977. The benefit derived from the rental expenditure was extinguished at the end of the year to which the payment related. Virtually, by definition, the rent is not a capital expenditure. (Emphasis added.)

That analysis is equally apropos here, and the Seventh Circuit's rejection of that analysis, we respectfully submit, is unsound.

Significantly, the Tax Court in Hoopengarner distinguished the decision of this Court in Commissioner v. Idaho Power, 418 U.S. 1 (1974), to which the Seventh Circuit referred in its opinion. The Tax Court's persuasive analysis is set forth below in its entirety (80 T.C. at 542-543, n. 6):

> This conclusion [that the ground rent payments are not capital

expenditures] does not run afoul of <u>Commissioner v. Idaho Power Co.</u>, 418 U.S. 1 (1974). In that case, the Supreme Court held that depreciation of transportation equipment used in the construction of capital assets constitutes part of the cost of acquiring those capital assets and therefore must be capitalized. The issue of whether an expense is construction-related turns on the individual facts. <u>Here, the lease payments were not construction-related since they did not hasten the completion or enhance the value of the building</u>. One of the factors influencing the Court [in <u>Idaho Power</u>] was that "capitalization of construction-related depreciation by the taxpayer who does its own construction work maintains tax parity with the taxpayer who has its construction work done by an independent contractor." <u>Commissioner v. Idaho Power Co.</u>, <u>supra</u> at 14. In this respect, we fail to see how requiring petitioner to include the lease payments in his basis in the building would put him on an equal footing with anybody. Moreover, petitioner did not himself construct the building, but rather had his "construction work done by an independent contractor." <u>Idaho Power</u> simply was not intended to extend to the instant facts. <u>As a further note, we might add that it would seem anomalous to require petitioner to capitalize payments</u>

made for a possessory interest in land as part of the basis of a building constructed on that land. The two should not be confused.

(Emphasis added.) We believe the Hoopengarner decision is analytically sound, and that the Seventh Circuit's rejection of it is unsound.[5/]

The Seventh Circuit claims that it is a basic tax principle that "income and expenses must be matched temporally in order to minimize the inevitable misallocation of resources that a taxing system creates." (837 F.2nd at 312.)

[5/] We also respectfully submit that the Seventh Circuit's decision to the mortgage commitment fees, the letter of credit fee and the other items was incorrect. Should this Court grant this Petition, we will brief those issues as well.

But that principle does not enjoy universal application in the tax law. As the Court noted in Blitzer v. United States, 684 F.2nd 874, 880 (Ct. of Cl. 1982):

> Section 162 does not require precise matching of income and expenses in the same year.

Indeed, the Internal Revenue Service takes the position that prepaid income is to be taxed entirely in the year of receipt, regardless of whether the preiod of proration is definite or indefinite. See, CCH 1987 Standard Federal Tax Reporter, §2830.703:

> It is the policy of the IRS to tax prepaid income in the year of receipt, whether the income is derived under contracts to furnish services or is prepaid rent, royalties, bonuses, etc. This is true regardless of whether the period of proration is definite or indefinite. . . .

Generally, amounts which in effect are paid for future services without restriction on the use of the funds by the recipient are income when received, notwithstanding the possibility of a refund, whether the taxpayer uses the cash or accrual method of accounting.

CONCLUSION

For the foregoing reasons, we respectfully request that the decision of the Seventh Circuit be reversed and the decision of Tax Court reinstated.[6/]

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[6/] Of course, the submission of this petition is without prejudice to our position that if a remand is necessary, the Tax Court should rule for petitioners.

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APPENDIX A

APPENDIX A

Martin H. Fishman, et al.,
Petitioners-Appellees, v.
Commissioner of Internal Revenue,
Respondent-Appellant

No. 87-1570

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Argued November 6, 1987

January 12, 1988, Decided

APPEAL-STATEMENT:

Appeal from Decision of the United States Tax Court.

COUNSEL:

Frances M. Allegrd, Tax Div., Dept. of Justice, Washington, D.C., for respondent-appellant.

Arthur W. Friedman, Miller, Shakman, Nathan & Hamilton, Chicago, Illinois, for petitioners-appellees.

Before POSNER and COFFEY, Circuit Judges, and NOLAND, Senior District Judge.[1/]

POSNER, Circuit Judge.

This appeal by the Internal Revenue Service from a decision by the Tax Court requires us to decide whether the costs incurred by an individual in starting a business may be deducted as current expenses (rather than having to be capitalized) under section 212(2) of the Internal Revenue Code, which allows an individual to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year . . . for the management, conservation, or maintenance

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[1/] Hon. James E. Noland of the Southern District of Indiana, sitting by designation.

of property held for the production of income."

The taxpayers formed a partnership to develop a shopping center on a piece of land which they did not own. In August 1976 the partnership obtained a standby commitment from a bank for a permanent mortgage, paying a $ 9,000 commitment fee to the bank and a similar fee to a broker. In September the partnership leased the development site from the owner for 50 years, at a monthly rental, beginning immediately, of $ 2,500. In November it obtained a construction-mortgage commitment from bank for a fee of $ 9,000, half of which was paid in 1976 and the other half in 1977. The partnership incurred a number of other expenses in 1976, including almost $ 8,000 in professional (mainly legal) fees and several thousand dollars in

advertising, promotion, consulting, office, and insurance expenses. Construction of the shopping center began on March 1, 1977, and was completed on September 1, by which time the partnership had signed leases with a number of tenants. The tenants had made deposits, and even paid some rental, before occupancy on September 1. But after deducting from this income the various fees and expenses that we have mentioned, the partnership reported net losses on its income tax returns for 1976 and 1977, losses which in turn showed up on the partners' income tax returns.

The Internal Revenue Service disallowed the deductions and assessed deficiencies on the partners, resulting in this litigation. The Tax Court held that the $ 9,000 brokerage fee paid to secure the standby commitment for the

permanent mortgage was a capital expenditure that must be amortized over the life of the mortgage and that the professional fees were nondeductible partnership organizational expenses (see 26 U.S.C. 709(a)), but that the rest of the fees and expenses were deductible under section 212(2) even though incurred before the shopping center was built and began to operate. 51 T.C.M. (CCH) 738, T.C. Memo 1986-127 (1986). In so holding the court relied on two earlier decisions, Hoopengarner v. Commissioner, 80 T.C. 538 (1983) (sharply criticized in Keller, The Capitalization of Construction Costs: Expanding the Scope of Idaho Power, 62 Taxes 618 (1984)), and Johnsen v. Commissioner, 83 T.C. 103 (1984). Hoopengarner was affirmed by the Ninth Circuit in an unpublished opinion, 745 F.2d 66 (1984), but Johnsen was

reversed by the Sixth Circuit in a published opinion, 794 F.2d 1157 (1986). We must decide whether we agree with the Ninth Circuit or with the Sixth Circuit and the Eighth Circuit, which has also rejected Hoopengarner. See Aboussie v. United States, 779 F.2d 424 (1985). Although an amendment to section 195 of the Internal Revenue Code requires that start-up costs incurred by individuals after July 1, 1984, be capitalized, the government's counsel told us at argument that there are thousands of pending disputes, involving in the aggregate many millions of dollars, over start-up costs incurred by individuals before the amendment went into effect -- so many disputes, indeed, involving so much money, that the government might have to ask the "Court of Nine" (as counsel

called it) to resolve the conflict among the circuits.

The case is fairly simple once it is located in the right matrix of statutory provisions and tax principles. Until 1942 the only statutory authority for deducting expenses incurred in profit-making activities was (the predecessor to) section 162, a provision expressly limited to expenses incurred "in carrying on any trade or business." Individuals who incurred expenses for the production of nonbusiness income -- for example, income from passive investments -- were out in the cold. That year Congress, in an effort to correct the unequal treatment of business and nonbusiness income, enacted the predecessor to section 212. The legislative history indicates that, other than by relaxing the requirement that the expenses be

incurred in the operation of a trade or business, section 212 was not intended to spare individuals who incurred expenses for the production of nonbusiness income from any of the "restrictions and limitations that apply in the case of a deduction under" section 162. H. Rep. No. 2333, 77th Cong., 2d Sess. 75 (1942); S. Rep. No. 1631, 77th Cong., 2d Sess. 88 (1942); see United States v. Gilmore, 372 U.S. 39, 44-45 (1963); Woodward v. Commissioner, 397 U.S. 572, 575 n. 3 (1970). "In enacting section 212, Congress intended to place all income-producing activities on equal footing." Snyder v. United States, 674 F.2d 1359, 1364 (10th Cir. 1982).

In a long line of decisions under section 162, the courts (including the Tax Court) have held that pre-opening" expenses, that is, expenses incurred

before the taxpayer's trade or business begins to operate (what we are calling "start-up costs"), are not deductible. See, e.g., Madison Gas & Elec. Co. v. Commissioner, 633 F.2d 512, 517 (7th Cir. 1980); Central Texas Savings & Loan Ass'n v. United States, 731 F.2d 1181, 1183 (5th Cir. 1984); Richmond Television Corp. v. United States, 345 F.2d 901, 907 (4th Cir.), vacated on other grounds, 382 U.S. 68 (1965) (per curiam); Waddell v. Commissioner, 86 T.C. 848, 895 (1986). They yield benefits over the entire life of the enterprise, and therefore must be capitalized. An example of such an expense is a fee for incorporating a new firm. The benefits of the fee will not be exhausted in one year -- the conventional period for determining whether an expenditure is fully deductible immediately, or must be

capitalized, see _Encyclopaedia Britannica, Inc. v. Commissioner_, 685 F.2d 212, 217 (7th Cir. 1982); _Snyder v. United States_, _supra_, 674 F.2d at 1365 -- but will continue for the life of the incorporated enterprise.

Although the taxpayers in this case thus could not deduct the expenses in question under section 162, the reason has little or nothing to do with the language of the section; as a matter of semantics, some of the expenses of carrying on a trade or business could be incurred before the trade or business went into operation. It has everything to do with the basic principle of tax law that -- subject to considerations of expediency discussed in _Encyclopaedia Britannica, Inc. v. Commissioner_, _supra_, 685 F.2d at 215, 217, but not invoked in the present case -- income and expense

must be matched temporally in order to minimize the inevitable misallocations of resources that a taxing system creates. (This principle is codified in section 263(a) of the Code, which forbids the immediate deduction of "capital expenditures" even if they are ordinary and necessary business expenses. See also 26 U.S.C. @ 161; Clark Oil & Ref. Corp. v. United States, 473 F.2d 1217 (7th Cir. 1973).) Because of the time value of money -- real riskless interest rates are positive -- a deduction taken today is worth more than one taken a year from now. Hence if an expense incurred to produce future income can be deducted from current income rather than postponed until it has borne its fruits, taxpayers will have an incentive to incur such expenses earlier than they would if there were no income tax; and tax law seeks, to

the extent compatible with revenue and distributive objectives, to interfere as little as possible with the pattern of expenditures that would exist in the absence of taxation. Richmond Television Corp. v. United States, supra, the leading case on the nondeductibility of pre-opening expenses under section 162, is explicit in linking its result to the principle of temporal matching. See 345 F.2d at 907-08; see also David R. Webb Co. v. Commissioner, 708 F.2d 1254, 1256 (7th Cir. 1983); Cleveland Electric Illuminating Co. v. United States, 7 Cl. Ct. 220, 227-29 (1985).

The principle that income and expense must be matched temporally is a limitation on the right to deduct expenses incurred in profit-making (more precisely, profit-seeking) activity, and is logically applicable to start-up costs

whether they are incurred by an individual, who can invoke section 212 as well as (if the income is business income) section 162, or by a corporation, which is confined to section 162. And we have seen that Congress intended to preserve all of section 162's restrictions and limitations in section 212, except the limitation to trades and businesses. So, for example, if a member of this panel rents a safe-deposit box to keep his securities in, he can deduct the annual rental under section 212; but if he buys a safe he must capitalize its purchase price -- he can't just deduct the price from his investment income in the year of the purchase. Otherwise taxpayers would have an incentive unrelated to the efficient use of resources to buy rather than rent safe places for their securities.

This case is trickier than our example. The Internal Revenue Service is not quarreling with the taxpayers' deducting the ground rents and other expenses in those months when tenants were occupying the shopping center and paying rent. Just the earlier months are in issue. It is as if the Service were challenging the deduction of a safe-deposit box rental paid for several months before the taxpayer deposited any securities. Yet we know that a taxpayer can deduct as a current expense the costs it incurs to find customers, tenants, etc. -- can even deduct the expense of finding a sublessee of his house. See Lord v. Commissioner, 10 T.C.M. (CCH) 521 (1951). The difference is the capital nature of the expenditure in this case. In Lord the house was there, and finding a tenant or series of tenants was a task

necessary to realize income from it. The ground rents and other expenses in this case were expenses incurred in creating the shopping center, not in operating it once it got going. The argument that these expenditures did not create capital in the way that money paid to a bricklayer would is shallow; many other inputs go into the creation of a capital good besides construction materials and labor.

It is true that section 212 does not distinguish explicitly between current expenses and capital expenditures, and does not (as does section 162 via section 161) incorporate section 263 by reference. However, the key word in section 212 -- "expenses" -- is more commonly associated with current expenses than with capital expenditures. More important, Congress from the beginning

wanted section 212 to be interpreted consistently with section 162, as we have seen; and it would be absurd if a partnership that built a shopping center could deduct its start-up costs but a corporation could not. A further clue is section 195, which before the 1984 amendment mentioned earlier allowed both corporations and individuals to amortize start-up costs. The provision would have been pointless as applied to individuals if they could have deducted such costs as current expenses, since that would almost always be preferable from the taxpayer's standpoint. The 1984 amendment simply made clear, what had previously been assumed, that indeed they could not deduct such costs as current expenses.

Focusing on the ground-lease rentals that the partnership paid before the shopping center was finished and

occupied, the taxpayers argue that rental is inherently a current expense. This is true enough if the rental is generating current revenue. Once the shopping center was in operation and throwing off income to the partnership, the rental that the partnership was paying to the owner of the land on which the shopping center had been built was a cost incurred to generate current income. So at least the Internal Revenue Service concedes in this case, making it unnecessary for us to decide whether a 50-year lease with an option to renew for 30 more years plus an option to buy might not be better analyzed as the purchase of a capital asset -- the leasehold estate.

Before the shopping center began generating any income to the partnership, the rentals paid to the owner of the land were start-up costs indistinguishable

from the expenses incurred in negotiating the lease; they were "advance payments in contemplation of future benefits." Southwestern Hotel Co. v. United States, 115 F.2d 686, 688 (5th Cir. 1940). If an electrical utility buys a truck to use in building a nuclear power plant, the purchase price of the truck -- as the taxpayers in this case concede -- is not deductible under section 162; it is part of the capital expenditure for the plant. Commissioner v. Idaho Power Co., 418 U.S. 1 (1974). Nor would it be deductible under section 212 if the utility happened to be an individual. See Woodward v. Commissioner, supra, 397 U.S. at 575. Even if the utility rented rather than bought a truck for this purpose, the (rental) expense would be a capital expenditure. If the partnership in this case had bought rather than

leased the land on which to build the shopping center, the purchase price would have been a capital expenditure; so would (so was) the price of an option to buy the land; and so is the cost of renting the land before the center is built -- that cost is the price of an option in a different form.

Regarding the other principal item allowed by the Tax Court, mortgage-commitment fees, the taxpayers argue that the Internal Revenue Service conceded in the Tax Court that those fees are deductible under section 212. That is not correct. The Service conceded that if the fees were "otherwise deductible" under section 212 it would not challenge their deductibility on the ground, for example, that they must be amortized over the term of the mortgages, as the Tax Court held with regard to the brokerage

fee for the permanent mortgage. The word "otherwise" is a reference to the Tax Court's belief, which the Service obviously does not share, that start-up costs incurred by individuals are deductible under section 212. There was no concession relevant to this appeal.

In holding that the Tax Court erred in allowing the deduction of ground lease rentals, commitment fees, and other start-up costs, we bypass two questions that might affect the outcome. The first is when the start-up period ceased, that is, when the trade or business, in this case the business of operating a shopping center, began. Such questions arise frequently in cases governed by section 162 alone because the taxpayer is a corporation, see, e.g., Blitzer v. United States, 684 F.2d 874, 880-81 (Ct. Cl. 1982) (per curiam) (holding that a

business may be said to have started before the actual receipt of income), and they should be decided the same way under section 212. The question remains for the Tax Court to decide on remand. Another open question is the proper tax treatment of the partnership's start-up costs. May they be amortized over the life of the shopping center? Section 195 would permit this -- but the statute did not go into effect until 1980, which is too late for these taxpayers. See Lathen & Lathen, The "Gap Period" Problem in Section 195, 62 Taxes 416, 418 (1984). The usual treatment before section 195 was passed was to classify the start-up costs of a trade or business as part of its "going concern value, see id., meaning that if and when it was sold these costs would be part of the trade or business's basis and hence would escape

capital-gains taxation. Section 195 provided more favorable treatment from the taxpayer's standpoint by allowing such costs to be amortized but, as we have said, is not available to these taxpayers. However, we need not try to rewrite the deficiency notices. The ground of the Tax Court's decision was erroneous, and that decision must therefore be

REVERSED.

APPENDIX B

APPENDIX B

MARTIN H. FISHMAN AND
HARRIET FISHMAN, ET AL.,[1]
Petitioners
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket Nos. 3916-81, 771-82, 772-82, 773-82.

51 T.C.M.(CCH) 738; T.C. Memo 1986 - 127

March 31, 1986.

COUNSEL:

Martin H. Fishman, pro se.

Arthur W. Friedman, for the petitioners in docket Nos. 771-82, 772-82, and 773-82.

Janet A. Engel, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

TANNENWALD, Judge: Respondent determined the following deficiencies in petitioners' Federal income taxes:

Docket No.	Taxable Year	Deficiency
3916-81	1976	$3,498
	1977	1,088
771-82	1977	20,141
	1978	4,463
772-82	1977	30,746
	1978	7,024
773-82	1977	454

After concessions, the issues for decision are (1) whether costs incurred by the partnership prior to November 1, 1977 were for the production of income, or for the maintenance, management or conservation of property held for the production of income, and in turn are deductible as expenses under section 212(1)[2/] or 212(2), or, alternatively, are deductible under section 162(a), and (2) whether the "professional" fees deducted by the partnership in 1976 are nondeductible partnership organizational expenses under section 709(a).

FINDINGS OF FACTS

Some of the facts have been stipulated and are so found. This reference incorporates the stipulations of facts and attached exhibits.

Petitioners Martin Fishman and Harriet Fishman resided in Lincolnwood, Illinois at the time they filed their petition in this case. They timely filed joint Federal income tax returns for the years 1976 and 1977. The trustee of petitioner Seymour N. Logan Insurance Trust - Trust B (the "trust"), Milton I. Shadur, resided in Glencoe, Illinois at the time he filed his petition. Timely Federal fiduciary income tax returns (Forms 1041) were filed for the trust for the taxable years ending June 30, 1977 and June 30, 1978, with the Internal Revenue Service Center, Kansas City, Missouri.

Petitioner Renee Logan resided in Chicago, Illinois at the time she filed her petition. She timely filed Federal income tax returns for the years 1977 and 1978 with the Internal Revenue Service Center, Kansas City, Missouri. Petitioner Harold Halpern resided in Chicago, Illinois at the time he filed his petition. He timely filed a Federal income tax return for the year 1977 with the Internal Revenue Service Center, Kansas City, Missouri.

Pursuant to a partnership agreement (the "agreement"), entered into by petitioners Harold Halpern and Renee Logan and dated August 21, 1975, the Johnstowne Centre Partnership (the "partnership") was created. The partnership was formed for "the limited purposes of leasing, constructing, developing, and otherwise dealing with

real and personal property in connection with the development of" a multi-unit commercial project (shopping center) on property in Champaign, Illinois (the "Project").

On September 19, 1975, petitioner Halpern, on behalf of the partnership, entered into an agreement by which the partnership obtained an option to enter into a 50 year ground lease of the property intended to be developed.

On February 15, 1976, the partnership entered into a trust agreement with the American National Bank and Trust Company of Chicago by which the partnership, the trust's sole beneficiary, empowered the trustee-bank to acquire a leasehold interest on behalf of the partnership in the property on which the Project was to be developed. On July 13, 1976, the

partnership exercised the aforesaid option and on September 30, 1976, the trustee-bank and the owner entered into a 50 year lease on the property for a monthly rental of $2,500.

In August 1976, the partnership received a permanent mortgage loan standby commitment in the amount of $900,000 from Mutual Home Savings & Loan. The partnership paid a $9,000 fee for the commitment and $9,000 to the firm of Salk, ward and Salk for their services in negotiating the commitment. In November 1976, the partnership received a $900,000 construction mortgage loan commitment from Busey First National Bank and paid it a $9,000 commitment fee, one-half of which was paid in 1976 and the balance in 1977. On December 31, 1976, the partnership entered into a construction contract with Turnkey, Inc.,

for the construction of the Project, calling for the completion of the Project by the fall of 1977.

On February 25, 1976, the partnership entered into its first lease with a commercial tenant. Six subsequent leases were entered into during 1976. During 1977, five additional leases were entered into, all prior to November 1. Security deposits were received by the partnership with respect to every lease. When ground breaking for the shopping center took place in March 1977, approximately 1/3 of the space in the shopping center had been leased to commercial tenants.

On March 23, 1977, the ground lease was amended to require the trustee-bank to provide an irrevocable letter of credit to be issued by First National Bank of Chicago. The letter of credit

authorized the lessor to draw on the partnership account in the amount of $500,000 in the event, among other things, that the Project had not been completed in basic accordance with the construction contract entered into by the partnership and Turnkey, Inc. The letter of credit was in lieu of a performance bond initially called for in the lease that the contractor had been unable to secure. The partnership paid a $4,930.55 fee to First National Bank of Chicago to obtain the letter of credit.

In September 1977, the partnership advised its prospective tenants that their space would be available on September 30, 1977, and that rent would not be due until November 1, 1977. This schedule was adhered to. The partnership's Federal income tax return

for 1977 states that it acquired the shopping center on November 1, 1977.

In addition to the rents and fees already mentioned, the partnership incurred the following expenses during the taxable year ending December 31, 1976, and during the first ten months of the taxable year ending December 31, 1977:3/

	12/31/76	10/31/77
Trust Fee	$166.00	$95.00
Business Promotion and Organization	1,798.00	0
Advertising	391.00	0
Professional Fees	7,930.00	0
Miscellaneous	655.00	20.19
Office Expense	293.00	0
Insurance	148.00	0
Consulting	1,340.00	0
Survey	666.00	0
Accounting and Legal	0	350.00
Travel and Auto	0	1,415.33
Telephone and Office	599.00	1,169.66

OPINION

Initially, we observe that the focus of this case is a narrow one. Respondent's disallowances are grounded for the most part on the so-called "preopening expense doctrine" which he claims is applicable both under section 162(a)[4/] and section 212. He urges us to overrule Johnsen v. Commissioner, 83 T.C. 103 (1984) and Hoopengarner v. Commissioner, 80 T.C. 538 (1983), affd. without published opinion 745 F.2d 66 (9th Cir. 1984). In the event we do not accede to his urging, with the exception of the brokerage fee and "professional" fees, see infra pp. 10-13, respondent does not argue that the disallowed items are otherwise not deductible. [5/]

In Hoopengarner v. Commissioner, supra, taxpayer acquired a leasehold

interest in a parcel of undeveloped land and proceeded to construct and operate an office building on the leased premises. We held that, pursuant to section 212(2), taxpayer could deduct rental payments under the ground lease, even though such payments were incurred before the building was completed and occupied and were thus nondeductible as "preopening expenses" under section 162. In so holding, we concluded that the "preopening expense doctrine" did not apply to section 212 since such section has no "trade or business" requirement. 80 T.C. at 543.

In Johnsen v. Commissioner, supra, a partnership acquired a leasehold interest in a piece of property on which it constructed and operated a project. In extending our holding in Hoopengarner v. Commissioner, supra, we held that,

pursuant to section 212(1) or 212(2), the taxpayer could deduct his share of construction loan commitment, permanent loan commitment[6/] and management and guarantee fees claimed by the partnership, even though these expenses were incurred prior to the opening of the project. 83 T.C. at 119.[7/] In so holding, we rejected respondent's contention that Hoopengarner was incorrectly decided and should be overruled. We made it clear that, at the time Hoopengarner was before this Court, respondent's arguments had been thoroughly considered and rejected and that our position had not changed. 83 T.C. at 117. Since our decision in Johnsen, the Ninth Circuit Court of Appeals has affirmed our decision in Hoopengarner (745 F.2d 66 (9th Cir. 1984)).[8/] We again reject respondent's

assertion that we incorrectly decided Hoopengarner and Johnsen.[9] Accordingly, we hold that with the exception of the brokerage and "professional" fees, discussed below, petitioners are entitled to all their claimed deductions.[10]

Respondent's concession as to the commitment fees, see supra note 7, expressly did not cover the $9,000 brokerage fee paid to secure the permanent loan commitment. Thus, we must address the capital expenditure versus deductible expense issue which is involved in determining the correctness of respondent's disallowance of the current deductibility in full of this item. Nothing in either Johnsen v. Commissioner, supra, or Hoopengarner v. Commissioner, supra, affects our disposition of this issue; those cases involved the current deductibility of

annual expense items or the amortizable portion of certain expenditures under the "preopening expense doctrine." It is well-established that a brokerage fee in respect of a loan commitment is a capital expenditure that must be amortized over the life of the loan. Duffy v. United States, 231 Ct. Cl. 679, 690 F.2d 889, 896 (1982); Lay v. Commissioner, 69 T.C. 421, 439 (1977); Longview Hilton Hotel Co. v. Commissioner, 9 T.C. 180, 182 (1947); cf. Rev. Rul. 57-400, 1957-2 C.B. 520. Consequently, respondent's disallowance of this item as a currently deductible expense is sustained.

Similarly, to the extent that we find that the $7,930 in "professional" fees deducted by the partnership in 1976 qualified as a partnership organizational expense under section 709(a), they were

properly disallowed, because section 709(a) provides that:

> [e]xcept as provided in subsection (b), no deduction shall be allowed under this chapter to the partnership or to any partner for any amounts paid or incurred to organize a partnership or to promote the sale (or to sell) an interest in such partnership. 11/
> Moreover, section 1.709-2(a), Income Tax Regs., defines "[l]egal fees for services incident to the organization of the partnership, such as negotiation and preparation of a partnership agreement" as an example of an organizational expense within the meaning of section 709.

To sustain their claimed deduction with respect to the "professional" fees, petitioners rely on the oral testimony of Mr. Fishman at trial that the bulk of these legal expenses were incurred in connection with the financing activities of the partnership. Respondent asks that we disallow the entire expense as a nondeductible organizational expense

because petitioners have failed to meet their burden of proof (see Rule 142(a); Welch v. Helvering, 290 U.S. 111 (1933)) that only a portion of these expenses were nondeductible. We agree with respondent.

We are satisfied that an unspecified portion of the "professional" fees were section 709 expenses. In order for this Court to make a reasonable estimate as to what portion of these fees are deductible expenses, see Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930), there must be sufficient evidence that at least the amount allowed in such an estimate was in fact incurred for deductible legal fees. Williams v. United States, 245 F.2d 559, 560 (5th Cir. 1957); Johnsen v. Commissioner, supra at 127. Although we recognize that it is improbable that the full $7,930 in legal fees were incurred

solely to form the partnership, Mr. Fishman's general testimony furnishes us with no basis for determining how much time and effort was spent between the two categories of activities and there is no other evidence in the record on this score. Thus, respondent's disallowance of the entire deduction for this item is sustained. See Merians v. Commissioner, 60 T.C. 187, 189-190 (1973).

To reflect the foregoing,

Decisions will be entered under Rule 155.

NOTES TO TEXT

1/ Cases of the following petitioners are consolidated herewith: Seymour N. Logan Insurance Trust - Trust B, Milton I. Shadur, Trustee, docket No. 771-82; Renee Logan, docket No. 772-82; and Harold Halpern, docket No. 773-82.

2/ Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all Rule references are to the Rules of Practice and Procedure of this Court.

3/ With respect to the 1977 taxable year, it appears from a comparison of the partnership return and the statutory notices of deficiency that respondent has only disallowed those expenses that were incurred prior to the opening of the shopping center on November 1, 1977.

4/ Section 162(a) provides that a taxpayer may deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business." It is well settled that section 162(a) operates to deny a taxpayer deductions for "preopening expenses" of the type here in issue which are incurred prior to the time that a business begins to function as a going concern and performs those activities for which it was organized. Richmond Television Corp. v. United States, 345 F.2d 901, 907 (4th Cir. 1965), vacated

and remanded on other issues 382 U.S. 68 (1965); Johnsen v. Commisioner, 83 T.C. 103, 114 (1984); Hoopengarner v. Commissioner, 80 T.C. 538, 540 (1983), affd. without published opinion 745 F.2d 66 (9th Cir. 1984); Goodwin v. Commissioner, 75 T.C. 424, 435 (1980), affd. without published opinion 691 F.2d 490 (3d Cir. 1982); Madison Gas & Electric Co. v. Commissioner, 72 T.C. 521, 566-567 (1979), affd. 633 F.2d 512, 517 (7th Cir. 1980).

5/With respect to the commitment fees, respondent expressly concedes their deductibility, see infra note 7.

6/We disallowed a portion of the permanent loan commitment fee because we deemed it to be excessive and not reasonable in amount, and thus not ordinary and necessary under section 212. Johnsen v. Commissioner, supra at 122-125. There is no issue as to reasonableness in the instant case.

7/As in Johnsen, respondent has conceded herein that, to the extent that the commitment fees are otherwise deductible under sec. 212, he will follow Rev. Rul. 56-136, 1956-1 C.B. 92, revoked prospecrively only, Rev. Rul. 81-160, 1981-1 C.B. 312, and will not contend that the commitment fees are capital expenditures. While we thus have no occasion to look behind respondent's concession, we note that respondent's position on this question was, to say the least, murky prior to the issuance of

Rev. Rul. 81-160. See Duffy v. United States, 231 Ct. Cl. 679, 690 F.2d 889, 893-894 (1982); Johnsen v. Commissioner, supra at 121 n.8; Francis v. Commissioner, T.C. Memo. 1977-170; Rev. Rul.75-172, 1975-1 C.B. 145.

8/We note that the Eighth Circuit Court of Appeals has recently declined to follow the Hoopengarner path. See Aboussie v. Commissioner, 779 F.2d 424, 428-429 n.6 (8th Cir. 1985).

9/Respondent asserts that we failed to consider his argument in Johnsen that the taxpayer had not shown that he had a possessory or proprietary interest in any income producing property, and thus did not qualify for a section 212 deduction. Although we dismissed this argument in Johnsen as having been untimely raised, we made it clear in Hoopengarner v. Commissioner, supra at 541, that while:

> [w]e are conscious that there is a requirement under section 212 that the taxpayer have a proprietary or possessory interest in the income producing property * * * [w]e have found that petitioner met this requirement by virtue of his ownership of the lease. * * * [Emphasis added. Citations omitted.]

To the extent that respondent is relying on the fact that the trustee-bank and not the partnership was the record lessee to distinguish the instant

situation from that which existed in Johnsen and Hoopengarner, we think he is grasping at a straw. Any such distinction is a distinction without a difference since the trustee-bank was clearly the agent of the partnership and performed no function other than that of the nominal lessee. Cf. Derr v. Commissioner, 77 T.C. 708, 724-725 n.11 (1981); People v. Chicago Title & Trust Co., 75 Ill. 2d 479, 389 N.E.2d 540, 545 (1979).

We note that section 195, which was added to the Internal Revenue Code as part of the Miscellaneous Revenue Act of 1980, Pub. L. 96-605, 94 Stat. 3521 and was amended under the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, disallows current deductions for start-up expenditures, but does allow the taxpayer to elect to amortize these expenditures for a period of not less than 60 months. Section 195, as amended, however, is only applicable to taxable years beginning after June 30, 1984.

10/In light of our allowance of petitioners' deductions under section 212, we find it unnecessary to address petitioners' alternative argument that these expenses are deductible under section 162. We do note, however, that for the same reasons to be outlined below, petitioners' claimed deductions for brokerage and "professional" fees would be similarly disallowed under a section 162 analysis.

[11]/Section 709(b) provides for the amortization of specified organizational expenses over a period of not less than 60 months, if the partnership so elects, effective with respect to taxable years beginning after December 31, 1976. The partnership made no such election.

No. 87-1735

In the Supreme Court of the United States

OCTOBER TERM, 1987

MARTIN H. FISHMAN, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether petitioners' distributive shares of certain costs incurred by their partnership prior to its completion of a shopping center complex were deductible under Section 212 of the Internal Revenue Code of 1954 (26 U.S.C.), as expenses incurred for the production of income.

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OCTOBER TERM, 1987

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COMMISSIONER OF INTERNAL REVENUE

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A22) is reported at 837 F.2d 309. The opinion of the Tax Court (Pet. App. B1-B22) is reported at 51 T.C.M. (CCH) 738.

JURISDICTION

The judgment of the court of appeals was entered on January 12, 1988. The petition for a writ of certiorari was filed on April 11, 1988. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. During 1976 and 1977, petitioners each owned an interest in a partnership that was formed in 1975 to develop a shopping center on a site in Champaign, Illinois. Use of this site was obtained by the partnership in July 1976 through a trust arrangement, which provided for a trustee-bank to acquire, on behalf of the partnership, a leasehold

interest in the property for 50 years, at a monthly ground rental of $2,500. In August 1976, the partnership received a permanent mortgage loan standby commitment from a bank; it paid a $9,000 commitment fee to the bank and an additional $9,000 fee to a firm for its services in negotiating the commitment. In November 1976, the partnership received a $900,000 construction loan from another bank, paying a commitment fee of $9,000. Pet. App. A3. On December 31, 1976, the partnership entered into a construction agreement with a contractor, providing that work on the shopping center was to be substantially completed by August 1, 1977, and fully completed 30 days thereafter (Pet. App. B6-B7).

On February 25, 1976, the partnership entered into a contingent lease with a commercial tenant. This agreement provided (Jt. Exh. 22-V):

> The term of this Lease and Lessee's obligations to pay rent hereunder shall commence on the earlier of: (a) August 1, 1977, (b) 90 days after notification to Lessee that its Premises are available to Lessee for purposes of Lessee making its tenant improvements, and (c) the day Lessee opens his business in the Premises.

The partnership entered into six similar lease agreements in 1976, and five more between January and November 1977. When groundbreaking for the shopping center took place in March 1977, approximately one third of the rental space at the shopping center had been leased to commercial tenants. Pet. App. A3-A4. On March 23, 1977, the ground lease was amended to require the partnership to provide an irrevocable letter of credit, which it obtained from a bank for a fee of $4,930.55 (Pet. App. B7-B8). In September 1977, the partnership advised its prospective tenants that their rental space would be available on September 30, 1977, and that rent would not be due until

November 1, 1977. This schedule went into effect as planned. Pet. App. A3, B8.

2. On its federal partnership information returns for the years 1976 and 1977, the partnership claimed losses of $59,875 and $40,977.05, respectively. The calculation of these losses included the deduction of various pre-operating expenses, such as loan commitment and professional fees, ground rent, and office costs.[1] Petitioners each filed federal income tax returns for 1976, 1977, and, in some instances, 1978, reflecting their distributive shares of the losses claimed by the partnership. On audit of the partnership, the Commissioner disallowed $59,875 and $20,517.71 of the losses claimed for the years 1976 and 1977, respectively. In the notices of deficiency sent to petitioners, the Commissioner determined that various of the expenses claimed by the partnerships in 1976 and 1977 were not currently deductible

[1] The following table summarizes deducted expenses that were incurred prior to November 1977 (see Pet. App. B9):

	Year Paid	
Item	*1976*	*1977*
Trust fee	$ 166.00	$ 95.00
Business promotion and organization	1,798.00	-0-
Advertising	391.00	-0-
Professional fees	7,930.00	-0-
Miscellaneous	655.00	20.19
Office expenses	293.00	-0-
Insurance	148.00	-0-
Consulting	1,340.00	-0-
Mortgage standby fee	22,500.00	-0-
Survey	666.00	-0-
Accounting and legal	-0-	350.00
Travel and auto	-0-	1,415.33
Telephone and office	599.00	1,169.66
Bank fee on letter of credit	-0-	4,930.55
Ground rent	23,389.00	17,500.00
Commitment fee	-0-	4,500.00
Totals	$59,875.00	$29,980.73

"because it ha[d] not been established that these expenditures were for ordinary and necessary business expenses." Petitioners' distributive shares of the disallowed partnership losses claimed on their respective returns for 1976, 1977, and 1978, were accordingly disallowed by the Commissioner. Pet. App. A4, B9.

3. Petitioners sought redetermination of the resulting deficiencies in the Tax Court, which ruled for petitioners in large part (Pet. App. B1-B22).[2] Relying on its previous reviewed decision in *Hoopengarner* v. *Commissioner*, 80 T.C. 538 (1983) (9-8 vote), aff'd, 745 F.2d 66 (9th Cir. 1984) (Table), and on its subsequent decision in *Johnsen* v. *Commissioner*, 83 T.C. 103 (1984), rev'd, 794 F.2d 1157 (6th Cir. 1986), the Tax Court allowed the deduction of the bulk of the partnership's expenses under Section 212 of the Internal Revenue Code,[3] as having been incurred for the production of income. The court explained that, under *Hoopengarner*, it was irrelevant whether such expenses were incurred prior to the commencement of the partnership's trade or business, in contrast to Section 162 of the Code, which would not permit the deduction of such "pre-opening expenses" as "business expenses" (see Pet. App. B10-B13, B18 n.4).[4]

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[2] The Tax Court agreed with the Commissioner that the $9,000 brokerage fee paid to secure the standby commitment for the permanent mortgage was a capital expenditure that must be amortized over the life of the mortgage (Pet. App. B13-B14) and that the professional fees were nondeductible partnership organizational expenses under 26 U.S.C. 709(a) (Pet. App. B14-B17).

[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.).

[4] Accordingly, the Tax Court found it unnecessary to decide whether the expenses in question were incurred before the partnership began to operate its business as a going concern.

4. The court of appeals reversed (Pet. App. A1-A12). The court noted that start-up costs are not deductible under Section 162 because they "yield benefits over the entire life of the enterprise, and therefore must be capitalized" (Pet. App. A9). The court found that the same principles should apply in the context of Section 212, which was designed to extend the benefits of Section 162 to income-producing activities that do not involve a "trade or business," but "was not intended to spare individuals who incurred expenses for the production of nonbusiness income from any of the 'restrictions and limitations that apply in the case of a deduction under' section 162" (Pet. App. A8, quoting H.R. Rep. 2333, 77th Cong., 2d Sess. 75 (1942)). Accordingly, the court of appeals held that start-up costs are not currently deductible under Section 212. The court thus expressly rejected the Tax Court's *Hoopengarner* decision, thereby aligning itself with the Sixth and Eighth Circuits. See *Johnsen* v. *Commissioner*, 794 F.2d 1157 (6th Cir. 1986); *Aboussie* v. *United States*, 779 F.2d 424 (8th Cir. 1985). Under the court of appeals' holding, if the costs in question were incurred before the commencement of the partnership's trade or business, they were capital expenditures that must be treated as part of the cost of acquiring the business; on the other hand, if they were incurred after the commencement of the business, they were currently deductible (Pet. App. A20). The court of appeals therefore remanded the case to the Tax Court to determine when the partnership's trade or business began.

ARGUMENT

Petitioners contend (Pet. 14-22) that their distributive shares of the partnership's pre-opening expenses are deductible under Section 212 of the Code. This contention was correctly rejected by the court of appeals. In addition, this

case does not merit this Court's review for several other reasons. First, review would be premature because the case is at an interlocutory stage. Second, the issue presented in this case is of little continuing importance because it has been definitively resolved by a statutory amendment applicable to tax years after 1984. Third, even as to earlier tax years, there is not a clear conflict in the circuits of the type that would require resolution by this Court.

1. At the outset, we note that this case is in an interlocutory posture at this time. The court of appeals has remanded the case to the Tax Court to determine when the partnership's business commenced as a going concern. Petitioners maintain (Pet. 22 n.6) that the resolution of this issue on remand will result in allowance of the disputed deductions.[5] Thus, it is possible that petitioners will prevail on remand without review of the decision below; if petitioners do not so prevail, the issue decided by the court below can be raised before this Court at a future time. Accordingly, the prudential considerations ordinarily applied by this Court counsel against granting certiorari at this interlocutory stage. See, *e.g.*, *Brotherhood of Locomotive Firemen & Enginemen* v. *Bangor & Aroostook R.R.*, 389 U.S. 327 (1967).

2. The issue presented in the petition has been definitively resolved by Congress for tax years beginning after June 30, 1984. In the wake of the Tax Court's decision in *Hoopengarner*, Congress acted to overturn that decision. Section 94 of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 614-615, amended Section 195 of the Code

[5] The government disagrees with petitioners on this point. Because the expenses in question were incurred prior to actual operation of the shopping center, it is the government's position that they predated the commencement of the partnership's trade or business. See, *e.g.*, *Bennett Paper Corp.* v. *Commissioner*, 699 F.2d 450, 452 (8th Cir. 1983).

to state that, except as otherwise provided in that Section, "no deduction shall be allowed for start-up expenditures" (I.R.C. § 195(a)). The term "start-up expenditures" is defined by Section 195(c)(1)(A) to include any amount paid or incurred in connection with "creating an active trade or business" or with "any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business." These amendments, which are effective for tax years beginning after June 30, 1984 (see § 94(c), 98 Stat. 615), clearly establish that start-up expenditures are not deductible under either Section 162 or Section 212 and thus they essentially codify the interpretation of Section 212 adopted by the court below. Indeed, the legislative history of these amendments specifically notes Congress's intent to overturn the *Hoopengarner* decision (see 1 Staff of the Senate Comm. on Finance, 98th Cong., 2d Sess., *Deficit Reduction Act of 1984,* at 283 (Comm. Print 1984)), and petitioners have acknowledged that Congress in 1984 "specifically set out to overrule [*Hoopengarner*]" (Pet. C.A. Br. 19). Thus, the question presented in the petition has little continuing importance.

Moreover, even as to the law applicable to cases not covered by the 1984 amendments, there is no "direct conflict" (Pet. 5) with the Ninth Circuit's affirmance of *Hoopengarner* that would warrant resolution by this Court. The Ninth Circuit affirmed the Tax Court's *Hoopengarner* decision in an unpublished memorandum (see 745 F.2d 66 (1984) (Table)). Under Rule 36.3 of the Rules of the Ninth Circuit, such an unpublished memorandum "shall not be regarded as precedent and shall not be cited to or by [the Ninth Circuit] or any district court of the Ninth Circuit," except for purposes relating to application of the doctrines of law of the case, collateral estoppel, and res judicata. Thus, if this issue were to arise again in the Ninth Circuit, *Hoopengarner* would not be binding precedent, and the

Ninth Circuit would be free to follow the subsequent decisions of the court below and of the Sixth and Eighth Circuits that have rejected *Hoopengarner.* See *Johnsen* v. *Commissioner,* 794 F.2d 1157 (6th Cir. 1986); *Aboussie* v. *United States,* 779 F.2d 424 (8th Cir. 1985).[6] Accordingly, there is no conflict of circuit precedent, and the conflict of decisions asserted by petitioners therefore provides no basis for review by this Court.

3. The court of appeals correctly rejected petitioners' contention that start-up costs are deductible under Section 212 for tax years beginning before June 30, 1984. Section 212 provides for the deduction of "all the ordinary and necessary expenses" paid or incurred "for the production or collection of income," or "for the management, conservation, or maintenance of property held for the production of income." Its predecessor, Section 23(a)(2) of the 1939 Code, was enacted following this Court's decision in *Higgins* v. *Commissioner,* 312 U.S. 212 (1941), which had held that expenses incurred by taxpayers in managing their individual securities portfolios were not expenses incurred in "carrying on any trade or business" within the meaning of the predecessor of Section 162(a) of the Code, and hence were

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[6] In addition to the fact that three courts of appeals have rejected *Hoopengarner* since it was affirmed by the Ninth Circuit, the likelihood that the Ninth Circuit would reach the same result in a future case is further diminished by the fact that the reasoning of the brief, unpublished memorandum affirming *Hoopengarner* has been undermined by subsequent developments. The court of appeals there had relied in large part upon Ninth Circuit precedent stating that "[b]ecause of its special expertise, the Tax Court's construction of the Internal Revenue Code should not be overruled unless it is unmistakably erroneous" (*Hoopengarner* v. *Commissioner,* No. 83-7693 (Sept. 14, 1984), slip op. 3). The Ninth Circuit has since explicitly repudiated that limited standard of review of Tax Court decisions. *Vukasovich, Inc.* v. *Commissioner,* 790 F.2d 1409, 1411-1413 (1986).

not deductible. In response, Congress in 1942 enacted Section 23(a)(2), which permitted "the deduction of some, but not all, of the [income-producing] nontrade and nonbusiness expenses of an individual taxpayer." *Lykes* v. *United States,* 343 U.S. 118, 121-122 (1952). See generally *United States* v. *Gilmore,* 372 U.S. 39, 45 (1963). As the court of appeals noted (Pet. App. A7-A8), the legislative history of the provision shows that it was intended to extend to nonbusiness income-producing activities some of the deductions previously available for business expenses, but was not intended to create an advantage for the former activities; thus, deductions under the new section were intended to be subject to "all the restrictions and limitations that apply in the case of the deduction * * * of an expense paid or incurred in carrying on any trade or business" (H.R. Rep. 2333, 77th Cong., 2d Sess. 75 (1942); S. Rep. 1631, 77th Cong., 2d Sess. 88 (1942)). The purpose of the new provision was "merely to enlarge 'the category of incomes with reference to which expenses were deductible.' " *United States* v. *Gilmore,* 372 U.S. at 45 (quoting *McDonald* v. *Commissioner,* 323 U.S. 57, 62 (1944)).

It is a fundamental principle of tax law that the cost of acquiring a long-lived asset must be capitalized. See generally *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1, 12-13 (1974); *Woodward* v. *Commissioner,* 397 U.S. 572, 575 (1970). Applying this principle, the courts of appeals have consistently held that Section 162(a) of the Code does not permit the current deduction of start-up, or pre-opening, expenses incurred by taxpayers in establishing a trade or business. See, *e.g.*, *Central Texas Savings & Loan Ass'n* v. *United States,* 731 F.2d 1181, 1183 (5th Cir. 1984); *Bennett Paper Corp.* v. *Commissioner,* 699 F.2d 450, 451-452 (8th Cir. 1983); *Madison Gas & Electric Co.* v. *Commissioner,* 633 F.2d 512, 517 (7th Cir. 1980); *Richmond Television Corp.* v. *United States,* 345 F.2d 901 (4th Cir.), vacated on other grounds, 382 U.S. 68 (1965); see also Pet. App.

B18 n.4. These courts have stressed, as did the court below (see Pet. App. A10-A13), that proper tax accounting requires a matching of income against expenses and have concluded therefore that start-up expenses incurred in making a business operational must be capitalized, rather than currently deducted, because such expenses represent the cost of acquiring the business as a whole and the business itself has a useful life that extends well beyond the year in which the expenses are incurred. See, *e.g.*, *Central Texas Savings & Loan Ass'n* v. *United States*, 731 F.2d at 1185; *Richmond Television Corp.* v. *United States*, 345 F.2d at 907; *Cleveland Electric Illuminating Co.* v. *United States*, 7 Cl. Ct. 220, 228 (1985).

It is well established that Section 212, just like Section 162, does not permit the current deduction of capital expenditures. This Court explicitly stated in *Woodward* v. *Commissioner*, 397 U.S. at 575 (footnote omitted), that, "[i]f an expense is capital, it cannot be deducted as 'ordinary and necessary,' either as a business expense under [Section] 162 of the Code or as an expense of 'management, conservation, or maintenance' under [Section] 212." See also Treas. Reg. § 1.212-1(n). Since, as discussed above, expenses incurred to establish an enterprise are capital in nature, such amounts should not be currently deductible under Section 212. Petitioners' contention that they are currently deductible and the Tax Court's *Hoopengarner* decision upon which petitioners rely are thus inconsistent both with the fundamental principle requiring capitalization of capital expenditures and with the well-understood intent of Congress in enacting the predecessor of Section 212, namely, "to provide for a class of nonbusiness deductions *coextensive* with the business deductions allowed by [the predecessor of Section 162(a)]." *Trust of Bingham* v. *Commissioner*, 325 U.S. 365, 374 (1945) (emphasis added).

Petitioners seek to avoid this conclusion by arguing (Pet. 17-18) that the items in question here, particularly the ground rental payments, typically are not considered capital expenditures. But, as the court of appeals explained (Pet. App. A16-A19), whether or not certain expenses are capital in nature depends upon the purposes for which the funds are expended. Where, as here, certain expenses are incurred in order to establish a business, those are capital expenditures, even though similar expenses might not be capital if incurred in the course of operating an ongoing trade or business. This point is well illustrated by this Court's decision in *Commissioner* v. *Idaho Power Co., supra.* There, the Court held that depreciation allowed with respect to trucks being used to construct a power plant could not be currently deducted, but should be capitalized as part of the basis of the plant, even though depreciation ordinarily gives rise to a current deduction. The Court found the capitalization of depreciation cost in this situation to be analogous to the capitalization of construction wages. The Court stated (418 U.S. at 13): "Of course, reasonable wages paid in the carrying on of a trade or business qualify as a deduction from gross income. * * * But when wages are paid in connection with the construction or acquisition of a capital asset, they must be capitalized * * *." The Court concluded that the depreciation "cost, although certainly presently incurred, is related to the future and is appropriately allocated as part of the cost of acquiring an income-producing capital asset" (*id.* at 11). This analysis is equally applicable to the expenses at issue here, and the court of appeals correctly held that they cannot be currently deducted if they were incurred before the partnership's business had begun.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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